

BEFORE THE  
**Federal Communications Commission**

WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

In the Matter of )

Price Cap Performance Review )  
for Local Exchange Carriers )

CC Docket No. 94-1

To: The Commission

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REPLY COMMENTS  
OF  
AMERICAN PETROLEUM INSTITUTE

The American Petroleum Institute (API), by its attorneys, hereby submits its Reply Comments in response to the Fourth Further Notice of Proposed Rulemaking (Notice) adopted in the instant proceeding on September 27, 1995 by the Federal Communications Commission (Commission), FCC 95-406 (released September 27, 1995). API has participated extensively in this proceeding, most recently submitting Comments on January 11, 1996.

**I. Overview**

In contending that a productivity offset, or X-Factor, must be calculated on a total company basis, the price cap LECs and the United States Telephone Association (USTA) have focused exclusively on one concern: economic validity. Their arguments for an "economically valid" X-Factor of

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2.8%, however, are entirely inconsistent with their actions. In May, 1995, eight of 12 price-cap LECs elected an X-Factor of 5.3% - the highest level available.<sup>1/</sup>

Economic validity, while important, is merely one of three "essential characteristics" identified by the Commission in its Fourth Notice of Proposed Rulemaking.<sup>2/</sup> The LEC industry has failed to address in any meaningful fashion the other two essential characteristics - that the X-Factor should (1) ensure consumer benefit and (2) be reasonably simple and based on accessible and verifiable data.

The price cap plan is intended to ensure just and reasonable *interstate* rates - a point the LEC industry also failed to adequately address. Given this jurisdictional limitation, and the absence of any demonstration that the total company approach satisfies two of the Commission's three "essential characteristics," if the Commission uses a total factor productivity (TFP) methodology, then it should calculate the X-Factor on an interstate-only basis.

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<sup>1/</sup> Notice, para. 8. GTE selected the highest factor for 38 of its 46 study areas.

<sup>2/</sup> Notice, para. 16.

## **II. Economic Validity Does Not Demand Precise Measurements of Interstate and Intrastate Productivities**

In their Comments, the NYNEX Telephone Companies propose a "fixed factor interstate adjustment," conceding that growth in the interstate market is more robust than in the intrastate market.<sup>3/</sup> This recognition of disparate productivity growth undermines any notion that economic validity demands a total company approach.

Further undermining the total company approach is NYNEX's acknowledgement, in the context of sharing obligations, that its competitive markets generate less revenue than its monopoly markets: "[i]f the sharing obligation is determined based on total company earnings, the reduced revenues in competitive markets could reduce a company's sharing obligation, and it may even cause the LEC to apply for a low-end adjustment."<sup>4/</sup> Because it is primarily the interstate arena in which competition has taken hold, it is entirely reasonable to conclude that it is the interstate arena in which the price cap LECs have made the greatest strides in productivity.

For the purposes of this proceeding, "economic validity" requires only a "reliable measure of the extent to

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<sup>3/</sup> Comments of the NYNEX Telephone Companies, December 13, 1995, at 18-21.

<sup>4/</sup> Comments of the NYNEX Telephone Companies, at 10.

which changes in LECs' unit costs have been less than the level of inflation."<sup>5/</sup> The comments of the price-cap LECs and USTA suggest that they define "economic validity" differently, focusing on precision rather than reliability. While the price cap LECs and USTA complain that any approach other than total company requires an arbitrary cost allocation, they have made no showing that an interstate-only allocation provides an unreliable measure of productivity.<sup>6/</sup> It should be remembered, after all, that the Christensen TFP methodology - whether original or simplified - is itself a model with its own deficiencies, flaws, and arbitrary allocations. Moreover, the level of precision which the LECs seem to urge may be unnecessary. Productivity levels fluctuate with normal economic activity - hence the LEC calls for "moving averages" while others, including API, support periodic re-examination.

Economic validity is not a goal in and of itself. The goal, instead, is a productivity offset that ensures just and reasonable *interstate* rates. Because a total company

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<sup>5/</sup> Notice, para. 16.

<sup>6/</sup> Christensen, Schoech, and Meitzen chose to make "no attempt to arbitrarily measure interstate and intrastate TFP growth in either [the] original TFP study or the simplified TFP method." Christensen, Schoech, and Meitzen, Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans, Appendix A to Comments of the NYNEX Telephone Companies, at 27.

approach exerts downward pressure on a productivity offset, thereby leading to increases in interstate rates, it cannot provide the Commission with the reliable measure it needs.

**III. A Total Company Approach Deprives Consumers of the Benefits of Productivity Gains**

The LEC industry urged the elimination of the consumer productivity dividend (CPD). Given this anti-consumer perspective, it is not surprising that their comments failed to identify any consumer benefit associated with calculating a TFP-based X-Factor on a total company basis. This absence should be taken for an admission that the total company approach offers consumers no benefit.

An essential characteristic of the X-Factor, according to the Commission's Notice, is the ability to "ensure that ongoing gains by the LECs in reducing unit costs are passed through to consumers."<sup>17</sup> The LECs have no incentive to pass such savings to consumers; indeed, it could be argued that supporting a position that leads to such a result would be inconsistent with a LEC's corporate obligations to its shareholders. It is the Commission's responsibility, then, to take steps to ensure that consumers benefit from ongoing productivity gains.

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<sup>17</sup> Notice, para. 16.

A TFP-based X-Factor that satisfies the "consumer benefit" test must be predicated on interstate-only data. Any other approach understates productivity, as NYNEX - with its proposed "fixed factor interstate adjustment" - acknowledges, and leads to interstate rates that are not "just and reasonable," because they are higher than warranted.

#### **IV. A Total Company Approach Further Complicates X-Factor Calculations**

LEC comments suggest that an X-Factor can be calculated on a total company basis with publicly-available information. Those comments, however, do not and cannot assert that total company calculations advance the Commission's companion concerns relating to simplicity.

USTA, in its discussion of output indices calculations, hints at the complexity associated with constructing output price indexes on a total company basis, conceding that "[c]onventional output price indices for price cap LECs' local, toll and intrastate access revenue are not available."<sup>8/</sup> USTA responds only vaguely to the Commission's stated concerns regarding "an ad hoc method we

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<sup>8/</sup> Comments of the United States Telephone Association on Fourth Further Notice of Proposed Rulemaking (USTA Comments), January 16, 1996 at 14.

find difficult to replicate",<sup>9/</sup> referring to construction methods that "use an approximation" to a chain-lined Paasche index and "are based on methods originally developed" by a pre-divestiture AT&T.

Calculating an X-Factor on a total company basis expands the Commission's task. It also complicates that task by introducing controversy and uncertainty. Neither result is appropriate for a productivity offset that should exhibit, as an essential characteristic, a degree of simplicity. Calculating an X-Factor on an interstate-only basis avoids these inappropriate results.

**V. Though It May Be A "Political Distinction Only," As USTA Asserts, Jurisdiction Does Impose Limitations On The Commission**

USTA contends that "[t]he Commission need not be concerned that a total company method of setting price caps for interstate rates somehow impermissibly exceeds the Commission's jurisdiction" because "[b]asing the productivity offset for interstate price caps on an economic measurement of total company LEC productivity does not constitute exercise of the Commission's authority with respect to intrastate communications service." <sup>10/</sup>

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<sup>9/</sup> Notice, para. 26.

<sup>10/</sup> USTA Comments at 29-30.

USTA misses the point. Basing a productivity offset on total company data implicates jurisdictional concerns because of the mismatch in federal/state regulation. USTA recognizes this mismatch in its discussion, noting that the regulatory environment and pace at which competition is being introduced in each state varies."<sup>11/</sup> Jurisdictional limitations prohibit the Commission from rectifying LEC windfalls that result from this federal/state mismatch. In the absence of consistent regulatory schemes, establishing an offset on a total company basis carries the virtual certainty that interstate rates will not be just and reasonable, in abrogation of the Commission's statutory duty.

According to USTA, the Commission should ignore the actions of the various state commissions in their regulation of price cap LECs and act solely "on the basis of sound economic principles."<sup>12/</sup> Essentially, USTA urges the Commission to disregard its jurisdictional limitations since, it contends, "jurisdiction is a political distinction only;" "[a]rbitrary regulatory boundary lines have no economic meaning or basis with regard to the input or output

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<sup>11/</sup> USTA Comments at 30.

<sup>12/</sup> USTA Comments at 30.



components of the production function."<sup>13/</sup> Thus, in USTA's view, the Commission should calculate a productivity offset on a total company basis because it is "economically valid;" nothing else merits consideration.

USTA's position stands in stark contrast to that espoused by the United States Supreme Court in Smith v. Illinois, in which the Court recognized that "[t]he proper regulation of rates can be had only by maintaining by the limits of state and federal jurisdiction...." Smith v. Illinois, 51 S.Ct.Rptr. 65, 69 (1930). In that seminal case, the Court observed that

[t]he separation of the intrastate and interstate property, revenues and expenses of the company is important not simply as a theoretical allocation to two branches of government. It is essential to the appropriate recognition of the competent governmental authority in each field of regulation.

51 Sup.Ct. at 68.

By urging the Commission to focus solely on that which it characterizes as "sound economic principles" and implement an X-Factor calculated on a total company basis, USTA - and the price cap LECs - would have the Commission impermissibly turn its back on established regulatory principles. They also would have the Commission disregard two essential characteristics of a productivity offset.

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<sup>13/</sup> USTA Comments at 28.

**WHEREFORE, PREMISES CONSIDERED,** the American Petroleum respectfully urges the Federal Communications Commission to maintain and further the goals of price cap regulation by taking action consistent with the views expressed herein.

Respectfully submitted,

**AMERICAN PETROLEUM INSTITUTE**

By: 

Wayne V. Black  
C. Douglas Jarrett  
Susan M. Hafeli

Keller and Heckman  
1001 G Street, N.W.  
Suite 500 West  
Washington, D.C. 20001  
(202) 434-4100

Its Attorneys

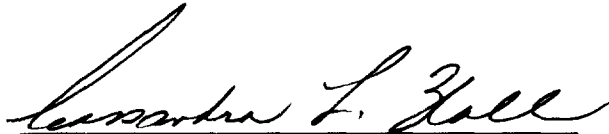
Dated: March 1, 1996

**CERTIFICATE OF SERVICE**

I, Cassandra L. Hall, a secretary in the law firm of Keller and Heckman, hereby certify that a copy of the foregoing was served by hand-delivery on this 1st day of March, 1996, to the following:

Industry Analysis Division  
Common Carrier Bureau  
Federal Communications Commission  
Room 100  
1250 23rd Street, N.W.  
Washington, D.C. 20554  
(computer disk)

Tariff Division  
Common Carrier Bureau  
Room 518  
1919 M Street, N.W.  
Washington, D.C. 20554  
(2 copies)

  
Cassandra L. Hall